

# **INTRODUCTORY LETTER TO THE BANQUE DE FRANCE'S ANNUAL REPORT**

**SUBMITTED TO**

**THE PRESIDENT OF THE FRENCH REPUBLIC,  
THE PRESIDENT OF THE SENATE, AND  
THE PRESIDENT OF THE NATIONAL ASSEMBLY**

**BY**

**CHRISTIAN NOYER,  
GOVERNOR OF THE BANQUE DE FRANCE**





I have the honour of submitting to you, as required by law, the report on the operations of the Banque de France, monetary policy and its outlook.

In accordance with tradition, I propose to set forth my thoughts on the growth environment and monetary policy, the state of the French economy and the main challenges that France needs to address in order to make lasting improvements to growth and employment.

### The European economy

In the second half of 2007, the European economy entered a period of great uncertainty that has weighed on the outlook for growth.

Growth in the euro area remained strong: after 2.9% in 2006, it is currently estimated at 2.6% for 2007, a performance that is slightly above the economy's growth potential. As a result, since early 2005 the unemployment rate has been on a downward path. It stood at close to 7% in spring 2008.

As in 2006, this growth has been broadly based since all of the components of demand have contributed to it. In the first phases of recovery, the contribution of external demand was decisive. But productive investment and, almost everywhere, household consumption subsequently supported the business cycle, which in most countries has enabled a welcome consolidation of public finances, with no adverse impact on economic activity.

However, the outlook for European growth is currently dominated by the uncertainty surrounding the impact of the financial crisis on the international environment. Although we cannot speak of a complete decoupling, the major emerging economies have displayed encouraging resilience during the episode of financial turmoil we are experiencing. Nonetheless, the world economy is currently facing several risks: that of a sharper-than-expected drop in consumption prompted by the fall in property prices; that of a further acceleration of energy and commodity price rises; and that of a spread of the financial crisis contributing to the slowdown of growth in the major economies. Moreover, these risks exist against the backdrop of persistent global current account imbalances, which increase the risk of a disorderly exchange rate adjustment.

### Inflation and monetary policy

Globalisation undoubtedly fostered the period of durably moderate inflation combined with rapid growth in the major emerging economies, which in turn supported the expansion of the world economy. The impact of the prices of many manufactured goods imported from countries with low labour costs largely offset rises in services prices and mitigated the temporary shocks such as those we have experienced in the euro area since 2000. This era is probably over. It seems that globalisation has stopped being spontaneously disinflationary – probably for a long time to come. In spite of the slowdown in the global economy due to the financial uncertainty, commodity prices, notably those of energy and metals, stimulated by continuing strong growth in emerging markets, now appear on an uptrend.

The sharp increase in oil and commodity as well as food prices appears to be primarily responsible for the acceleration of inflation observed in the euro area in 2007. The Eurosystem's monetary policy has principally aimed, in line with the mandate assigned to it by the Treaty, to maintain price stability in a lasting manner. Against the backdrop of sustained growth in the euro area, the Eurosystem's main key rate was raised from 3.5% to 4% in the first half of the year. From summer 2007 onwards, the ECB's Governing Council kept the monetary policy stance unchanged: while real GDP growth was moderate but stable, the Council noted the presence of strong short-term upward pressure on inflation and continuing upside risks to price stability over the medium-term, in a context of very vigorous money and credit growth. It also took account of the particularly high level of uncertainty resulting from the turmoil in financial markets.

In addition to temporary shocks, inflation is largely determined by the expectations of economic agents, i.e. households, enterprises and financial markets. These agents are increasingly well informed. They quickly perceive developments that threaten their purchasing power or the value of their savings. If they consider that monetary policy is unlikely to contain inflation, they adjust their behaviour very rapidly, for example by asking for higher wages, thereby triggering a wage-price spiral; or by demanding greater remuneration of their savings, which pushes up long-term interest rates and weighs on investment and employment.

It is, therefore, first and foremost by anchoring inflation expectations that monetary policy can make an effective contribution to economic growth. If monetary policy is credible, confidence prevails and economic agents make their decisions in a more reliable environment.

Maintaining the internal value of money also means preserving consumers' purchasing power. French citizens, who are clearly very attached to price stability, know this. Conversely, inflation is a form of confiscation, which primarily affects the least privileged households. In a modern economy, the social contract is based on the confidence that citizens have in their currency. With the euro, French citizens now possess one of the world's two foremost currencies, whose legitimacy is based on the stability that it bestows on their savings and purchasing power. The Banque de France, within its remit, intends to devote all its energy to safeguarding this stability.

### The French economy within the global economy

In spring 2008, the picture of the French economy is mixed. Several key indicators appear positive: the annual growth rate is currently still close to 2%, the number of job seekers is continuing to fall and we are no longer seeing excessive price hikes on the property market.

On the other hand, France has for several years recorded a substantial trade deficit, which widened further in 2007 to nearly EUR 40 billion. The rising price of oil is obviously a factor, but it was the trade surplus excluding energy that posted a decline, falling from around EUR 18 billion in 2006 to EUR 6 billion in 2007. True, thanks to the euro area, the French economy is shielded from financial turbulence that, in the past under such circumstances, would have jeopardised the stability of its currency. Nevertheless, although under Monetary Union the external balance is no longer a short-term financial constraint, it remains a telling indicator of an economy's ability to remain competitive.

What can this widening trade deficit be attributed to? French domestic demand, boosted by higher household consumption than the European average, may have been one explanatory factor in the past. France's declining

export performance may be ascribed to the inadequate degree of geographical and sectoral specialisation, but this cannot account for the deterioration in the country's trade balance since 2005.

More fundamentally, the price-competitiveness of French industries has decreased significantly in recent years. The appreciation of the euro has certainly played a role in export sectors whose competitors are located in other currency areas. But Germany, which has the same currency, has not suffered the same woes, and it is mainly France's intra-euro area trade that has deteriorated. The crucial factor behind our difficulties appears to be the indirect effects of the reduction in the working week. French competitiveness has been impacted by wage increases and catch-ups associated with the reduction in the working week, while Germany has reaped the rewards of several consecutive years of wage moderation.

As regards exchange rates, I believe that the terms of the debate need to be clarified. The public's comments and attention are focused on the appreciation of the euro against the dollar. However, in addition to this bilateral exchange rate, it is important, from a macroeconomic perspective, to analyse the movements of the effective exchange rate, i.e. the changes in the euro exchange rate vis-à-vis the currencies of all trading partners. It is also necessary to take account of the changes in relative prices with these same partners to acquire a better understanding of the real impact of these exchange rate fluctuations. Other factors, such as companies' markup behaviour, quality and innovation, should not be disregarded. Lastly, it should be noted that the appreciation of the euro has considerably cushioned the shock of the rise in oil and commodity prices, which are essentially denominated in dollars.

However, we are currently in a period characterised by ample and disorderly fluctuations in the main currencies of developed countries and an insufficient degree of flexibility for a large number of currencies of emerging countries. This situation undeniably calls for concerted and determined action on the part of the world's leading countries.

The determination of the exchange rates of the main world currencies reflects the confrontation of powerful forces in a globalised economy and financial system.

While capital moves freely and instantaneously across countries, exchange rate regimes differ significantly in terms of their flexibility. This situation may lead to adjustments according to the exchange rate regime considered, rather than economic fundamentals, both between monetary areas and within a same region, like in Asia. A smooth unwinding of global imbalances therefore calls for more flexible exchange rate regimes, in particular in countries with large current account surpluses. Introducing greater flexibility should no doubt be a priority of the G7 Heads of State and Government in the coming months.

Indeed, greater flexibility in exchange rate regimes is in the interest of emerging countries themselves. By maintaining too tight a peg to the dollar, some countries are led to largely "import" the US monetary policy, which is often totally unsuited to their economic situation. This situation may result in inflationary pressures that are difficult to contain, which then tend to spread to the rest of the world.

### Pursuing structural reforms

In order to lastingly consolidate our country's growth dynamics, a sharp rise in the labour input rate is required. The European countries whose per capita income is expanding most rapidly are those which have expanded their workforce via higher employment rates. France has significant growth pools thanks, in particular, to its demography. If these pools were tapped through appropriate policies, France should, in a few years, be able to substantially raise its per capita income and at least catch up with the best European performers.

This catch-up is within our reach. Indeed, since the start of 2008, the French economy has benefited from the reforms already initiated, but efforts must be pursued. As I previously mentioned, this requires a radical change in habits and policies.

It is neither economically nor socially desirable for France to be among the OECD countries with the lowest annual number of hours worked per employee or among the euro area countries with the lowest employment rate of older workers. In this respect, very significant progress has been made: improving the functioning of the public service, merging the

French national employment agency (ANPE) and the unemployment insurance fund (UNEDIC), facilitating overtime for employees, establishing a new conventional breach of employment contract and introducing employment contracts more in line with employers' expectations, in particular a fixed-term specific purpose contract and a wage portage contract. These measures should distribute purchasing power in the economy and foster job creation by companies.

Naturally, the reform of special pension schemes, which was postponed several times and that your Government has now implemented, is a clear signal of the will to reform that is vital for France today. It will make it possible to strengthen the foundations of a welfare model faced with the challenge of an ageing population.

These reforms must be pursued, and the work of our economists as well as the conclusions of many other institutions necessarily call for further adaptation of the structures of the French economy in order to meet the requirements of globalisation. Thus, at a time when France's relative competitiveness is starting to improve, it is important to be extremely vigilant about developments affecting wage formation in general and minimum income schemes and the minimum wage (SMIC) in particular.

Wage growth must be based on redistribution, at the level of each company, of part of productivity gains, otherwise there is a risk that higher wages could push up prices and immediately offset purchasing power gains, penalising in particular those in precarious positions. Conversely, too rapid a rise in the minimum wage, with horizontal and indiscriminate effects, could also pose a threat to the competitiveness of some of our companies, and thus to growth and employment.

It seems advisable to develop, in a clear and consistent manner, work incentives, by making employment more rewarding than inactivity. For instance, current studies regarding the link between unemployment benefits, efforts to reintegrate unemployed persons into the labour market and training offered to redundant workers, appear promising. Equally appropriate is the work on replacement income that aims to ensure, for each person, that income increases in line with the level of activity. Choosing to work part time is also a way to reconcile work and family life, which is

preferable to inactivity. It should be stressed that all these measures are perfectly consistent with efforts to raise purchasing power, both at the individual level and that of the French economy as a whole.

Needless to say, reforms should be conducted not only on the labour market but also on the goods market. The countries that have succeeded in implementing such reforms are those which have developed a virtuous circle of activity, productivity and employment. If one link is missing, the reforms implemented elsewhere will not have all their anticipated effects.

We know that France has vast labour pools in market services. We also know that by their very nature, most of these jobs cannot be offshored. However, many obstacles still lie in the way of their development. It is too often difficult, even prohibited, in France to produce or sell services.

A thorough review of all the legal and regulatory conditions governing a wide range of commercial and services activities therefore appears to be an urgent priority. In this respect, the draft law on the modernisation of the economy contains very important provisions.

### Reducing government deficits

The situation of French public finances has deteriorated: in 2007, the government deficit stood at 2.7% of GDP and public debt at 63.9% of GDP.

France has committed itself to complying with the revised Stability and Growth Pact, and meeting this commitment, as embodied in its stability and growth programme, is a token of the country's credibility vis-à-vis its European counterparts.

In the interest of France's economy and citizens, particular attention should now more than ever be paid to the sustainability of public finances. The role traditionally assigned to public spending and welfare is to enable a better allocation of resources in the economy, foster the desired redistribution of income,

and, if the necessary conditions are in place, help stabilise economic cycles. However, these three roles are more difficult to carry out in a globalised economy that reduces room for manoeuvre and increasingly generates growing competition between the most attractive tax systems and the most effective public policies. A number of major challenges thus emerge.

First, a critical review of the quality of public spending is necessary. France is the country in the euro area with the highest level of public spending as a percentage of GDP. Priority should therefore be given to forward-looking spending that supports reforms. In this respect, the steps that have been taken to carry out a general review of public policies appear crucial. Careful attention should be paid, in particular, to the "defensive" cuts in social contributions aimed at offsetting the specific constraints that weigh down on the financial situation of French firms. In this respect, the effectiveness of employment promotion schemes over the long term needs to be examined. These schemes are useful, or even essential, when they allow those deprived of equal opportunities to integrate into the labour force; they are less justifiable when, conversely, they are used to financially offset the effects of rigidities in the functioning of the labour market, and which more specifically affect hiring decisions.

Second, structural expenditure should be reduced. The government has already started doing so by introducing a series of streamlining measures within the ambitious framework of the general review of public policies that you have initiated. More than elsewhere, France has a high quality civil service, which enables it to provide a very large number of services at the lowest cost to the community. However, of all developed countries, France has recorded the highest growth in public sector jobs in recent years. Central government, in particular, has not downsized its staff in proportion to the functions transferred to local authorities, whereas the latter have recruited massively to fill these new positions. The retirement of large generations of civil servants represents an opportunity to be seized in order to counter this development and, in so doing, restore fiscal room for manoeuvre.

As the government has just very clearly reaffirmed, the financing of the social security system has finally become a priority. Over the years, the general social security account has posted a lasting deficit. Given that age-related public expenditure is expected to continue increasing at a fast pace in the coming years, the social security account needs to be rapidly brought back to equilibrium in order to guarantee the sustainability of the French social security system. To achieve this objective, a general increase in social security contributions cannot be envisaged because of the negative effects that such a rise would have on labour demand and households' purchasing power. Furthermore, the level of taxes and social security contributions in France is already very high compared to other industrialised countries. The structural reforms aimed at boosting employment and, via the further pension scheme reforms, extending the number of working years will contribute to progressively increasing receipts and reducing welfare expenditure. These reforms should ideally go hand in hand with the introduction of measures that help to contain welfare spending more rapidly, in particular in the areas of health care and pensions.

Far-reaching reforms are therefore more than ever needed in order to lighten the burden that we will pass on to future generations. What would be legitimate if this debt were used to establish a productive capital that would benefit these generations, is in fact economically inefficient and morally unjust when future generations have to finance current generations' spending. Such a transfer is especially reprehensible since sustainable development is one of the new priorities of public

policies and the quality of the environment passed on to future generations has never inspired and guided public action to such an extent.

\*  
\*                      \*

France has embarked on a series of in-depth reforms that it must pursue in order to maintain, and, if possible improve, its relative competitive position on the global market. It boasts human and technological advantages that are the envy of many of our counterparts, but its economy is hampered by the numerous rigidities introduced over the years and that appear particularly damaging in today's open and competitive world.

Reforms are clearly a necessity. We have the capacity to achieve more growth, more employment and more purchasing power provided that we allow our economy to exploit its full potential. Although globalisation generates greater insecurities here and there, it also offers opportunities that we must be prepared to seize.



Christian Noyer

